

Private Letter Ruling: Composite returns may be filed on behalf of nonresident individual partners of partnerships.

February 22, 2000

Dear:

This is in response to your letters dated November 4, 1999, and January 14, 2000 in which you request a Private Letter Ruling on behalf of the listed partnerships. The Private Letter Ruling will bind the Department only with respect to the listed partnerships for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither the listed partnerships nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented (footnotes have been incorporated into the text) are as follows:

On behalf of each of the above referenced taxpayers (the "partnerships"), we respectfully request a private letter ruling granting permission to file composite returns on behalf of certain nonresident partners for Illinois personal income tax purposes with respect to the 1999 tax year. For the reasons set forth below, we believe each of the partnerships meets all of the qualifications for filing a composite return. It should be noted that the partnerships separately meet Requirements 1 and 2, and collectively meet Requirement 3 as stated below.

By way of background, each of the partnerships is doing business in Illinois. To the extent the partnerships are earning income in Illinois, the nonresident partners associated with such partnerships are deriving income from the State by virtue of their distributive shares of partnership income. All of the partners seeking inclusion in the composite returns meet the following requirements:

1. Each partner is an individual or an S corporation owned by one individual. It should be noted that during 1999 an entity change occurred that affects one or more of the partnerships (denoted by an asterisk "*") referenced above. With respect to each such partnership, one or more of the partners established a separate S corporation for the purpose of holding his or her respective partnership interest. Each S corporation has one shareholder only, that shareholder being the individual/partner having ultimate ownership of the partnership interest. The only asset held by each S corporation is the partner's proportionate interest in the partnership. Since the S corporation is a pass-through entity, distributions made by the partnership to the S corporation are passed through to the individual shareholder (the same individual who would receive such distributions if an S corporation had not been interjected in the ownership chain). Upon close examination, it is clear that the substance of this arrangement is indistinguishable from instances where partnership distributions are made directly to partners in their capacity as individuals. Thus, the relationship between the partnerships and the ultimate partners is essentially the same, whether or not an S corporation exists as a middle tier between the partner and partnership. Based on the

foregoing, we believe that to grant permission to include these partners in the composite group would be consistent with the substance and intent of the laws and regulations of the State;

2. Each partner is a nonresident of Illinois for the entire taxable year; and

3. Each partner has no other Illinois source income except such other Illinois source income that would be reported on another composite return filed by one or more of the other partnerships.

With respect to the last requirement, it should be noted that the other Illinois source income relates to the distributive shares derived from one or more of the partnerships mentioned above (i.e., those entities that will simultaneously be filing composite returns in Illinois if permission to do so is granted by the State). It is our understanding that the intent underlying this requirement is to ensure that for income tax purposes, all of the nonresident partners' Illinois source income is reported. In this case, all of the partners joining in the filing of the composite returns of the partnerships have no other Illinois source income for the 1999 tax year except the income that is derived from each individual's partnership interest in one or more of the other partnerships. For example, a partner of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxx may have Illinois source income derived from his partnership interest in not only xxxxxxxxxxxxxxxxxxxxxxxxxxxxxx, but also xx, xx, and the xxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. However, this partner would have no other Illinois source income. Therefore, if every one of these partnerships is permitted to file a composite return in the State, then all of the nonresident partners' Illinois source income would be properly reported in one or a combination of composite returns. In addition, the S corporations will comply with the requisite tax return filing requirements of the State and will pay any applicable minimum tax.

The primary purpose of allowing a partnership to file a composite return is to ease the compliance efforts of the taxpayer in preparing a large number of individual returns, as well as the administrative burden of the State in processing these returns. Since there will be a significant number of nonresident partners joining in these composite returns, the compliance and administrative burdens associated with handling so many separate individual returns will be substantially diminished if the partnerships are permitted to file composite returns.

Based on the above, we believe it is both prudent and beneficial for Illinois to allow all of the partnerships to file composite returns in the State. All of the partners' Illinois source income will be reflected on one or more of the composite returns so that no Illinois source income will go unreported. The potential savings in time and effort associated with administering a handful of composite returns compared to hundreds of individual returns will be considerable. Accordingly, we respectfully request that each of the partnerships be permitted to file a composite return for the 1999 year.

A schedule showing the names, addresses and federal employer identification numbers of the partnerships, total number of partners in the partnerships,

the number of partners joining in the composite returns, and the tax year for each of the partnerships is annexed hereto.

In the event that permission to file composite returns is not granted, we respectfully request an opportunity to discuss our case prior to the issuance of a written response from your office.

RULING

The general rule under section 502(a) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 *et seq.*) is that every person liable for Illinois income tax must file an income tax return. Section 502(f) of the IITA creates an exception to this general rule in the case of certain taxpayers who are partners or S corporation shareholders. The section provides:

The Department may promulgate regulations to permit nonresident individual partners of the same partnership, nonresident Subchapter S corporation shareholders of the same Subchapter S corporation, and nonresident individuals transacting an insurance business in Illinois under a Lloyds plan of operation, and nonresident individual members of the same limited liability company that is treated as a partnership under Section 1501(a)(16) of [the IITA], to file composite individual income tax returns reflecting the composite income of such individuals allocable to Illinois and to make composite individual income tax payments.

Under the authority of IITA section 502(f), Illinois Income Tax Regulations section 100.5100 sets out the requirements for a taxpayer to be eligible to be included in a composite return. Section 100.5100(a) states:

In general. A composite return may be filed on behalf of nonresident individuals, trusts, and estates who derive income from Illinois and who are partners, or S corporation shareholders, or who transact insurance business under a Lloyds plan of operation. The respective partnership, S corporation or insurance business shall file such composite return and shall make composite income tax payments.

Section 100.5100(b) states:

Eligibility. The right to be included in a composite return is limited to nonresident and resident individuals, trusts, and estates who are partners of the same partnership, shareholders of the same S corporation, or individuals transacting an insurance business in Illinois under a Lloyd's plan of operation. The eligibility of resident individuals, trusts, and estates is conditioned upon compliance with subsection (c) of this Regulation.

Example: The Acme partnership consists of a general partner and fifty(50) limited partners. The general partner is a regular corporation, and the limited partners consist of twenty-six (26) nonresident individuals, twenty (20) resident individuals, an S Corporation, a partnership, a nonresident trust, and a estate. The twenty-six (26) nonresident individuals, the nonresident trust, and the nonresident estate are automatically eligible to be included in a composite return. The twenty (20) resident individuals may

be included in the composite return with the nonresidents if the Department grants their petition. None of the other entities may be included in the composite return.

Section 100.5100(e) addresses the case where a nonresident partner or S corporation shareholder has other Illinois source income.

Nonresident individuals, trusts, and estates with Illinois source income other than from a partnership, S corporation, or Lloyd's plan of operation may, but need not, be included in a composite return. If such nonresidents are included in a composite return, they will not be permitted to claim credits on their individual returns for their shares of the composite tax payments unless the authorized agent files a petition with the Department of Revenue requesting permission for the nonresidents to claim such credit and the petition is granted.

Your letter states that one of the requirements for the filing of a composite return is that each partner not have other Illinois source income. That statement is not correct. It is not a requirement for the filing of a composite return that each individual partner have no other Illinois source income except that attributable to the partnership making a composite return. Regulations section 100.5100(e) specifically allows partners with other Illinois source income to be included in a composite return, but requires Department permission in order to claim credit on individual returns for shares of composite tax payments. And in any event, section 100.5100(e) does not apply to the facts as you have represented them, since each partner's only Illinois source income is from a partnership.

Moreover, note that a composite return may be filed by a partnership without including all partners. For example, Regulations section 100.5100(d) states specifically that a composite return does not have to include all partners eligible to join in a composite return. Individual partners choosing against inclusion in a composite return must separately satisfy their Illinois filing and payment obligations. Therefore, even if a partner with other Illinois source income is not included in a composite return, that does not prevent the partnership from filing such a return on behalf of the other eligible partners.

Applying the provisions of the IITA and Regulations discussed above to the facts here, each of the partnerships you have listed may file a composite return that includes the Illinois source items of each of the *individual* nonresident partners of the respective partnerships. Under regulations section 100.5100(b) the individual nonresident partners are automatically eligible to be included in the composite return. However, neither the S corporation partners nor the sole individual shareholders of such S corporation partners may be included in such composite returns. Regulations section 100.5100(a) specifically limits the right to be included in a composite return to *individual* partners (or a trust or estate). The S corporation partners are not individuals, and the sole shareholders of such corporations are not partners. Accordingly, they may not be included in the composite returns filed by the listed partnerships.

This ruling applies to the 1999 taxable year and all future years during which the pertinent statutory law, case law, and rules and material facts discussed

above remain unchanged. The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts in this ruling.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)